INVESTMENT ADVISORY COMMITTEE

QUARTERLY MEETING

MINUTES OF MEETING HELD ON 24/11/09

Present	In attendance	Apologies
Mike Yardley Ewan Smith John Deane Andy Carter Andrew Barrie	Phil Mowbray (Barrie & Hibbert) Nick Leitch (Scottish Life) Helen Carter (Scottish Life) Robin Herd (Scottish Life) David Bird (Royal London) Robert Talbut (RLAM) Peter Watts (Barrie & Hibbert)	

ACTION

1. REVIEW OF PREVIOUS MINUTES

The minutes of the 25th August IAC meeting were approved with one change notified to the third bullet point in section 2. EFS clarified that the UK/overseas equity benchmark analysis indicated that a 55%/45% blend provided the mix that maximised the diversification benefit of overseas equities relative to a staring point that is 100% UK Equities – the previous meeting minutes have been updated to reflect this. **RH**

The action points arising from the 25th August meeting were then reviewed:

- PM explained that he had received the Barra output but would require further technical detail. RT will approach Barra for further information and a contact person for PM to speak to. **RT/PM**

- It was noted that the extra management information requested by MY and EFS has been added into the IAC report.

- PM proposed discussing the query about 10 year spot returns with EFS post meeting rather than by issuing a technical note. **EFS/PM**

- RT confirmed that the **Cautious Long Managed Strategy** tactical asset allocation was altered after the last meeting as requested by the IAC, by reducing exposure to equities and corporate bonds and switching into index-linked bonds.

- RT confirmed that the **United Friendly managed fund** benchmark had been reviewed and that he is in the process of updating this change within performance measurement systems. **RT**

- The following funds were highlighted as "on watch" at the last meeting, but the IAC agreed that no further action was now deemed necessary:

  - **UBS Managed and UK Equity funds** – performance has significantly improved over the previous 12 months.

- Discussion on the following action points took place during the meeting:
  - Fixed Interest fund
  - Duration bond funds
  - Life Property fund structure
  - Managed funds
  - JPMorgan Premier Equity Growth
  - Schroder UK Mid 250
  - Close Teams funds
  - Fidelity International
  - Investec Global Free Enterprise
  - Artemis European Growth
  - Baillie Gifford funds

2. GOVERNED PORTFOLIOS AND MANAGED FUNDS – BENCHMARK AND TACTICAL REVIEW

Information was presented by PM, RT and HC - the key points were as follows:

- Economic outlook – the forecast expected nominal gilt yields reduced over both the short and long term. Short term inflation expectations increased, however projected inflation over a 5 year horizon and beyond has increased. There was a reduction in the projected expected defaults on corporate bonds in the short-term.

- Current equity volatility has moderated recently following a period of exceptionally high volatility. However it is still running above historic levels, and as a result this is impacting the long term assumption.

- The stochastic model was updated to reflect the new market conditions. The impact on the forecast asset class returns since the last quarter was, in summary, as follows:

  - Expected nominal returns from gilts over all terms decreased.
  - Expected nominal return from corporate bonds has decreased reflecting a reduction in the credit risk premium.
  - Expected real returns from equities are lower, reflecting a reduction in underlying risk-free returns.

- As a consequence of the increase in long term equity volatility, the analysis indicated a slight increase in the measured benchmark risk:

  - The benchmarks and tactical positions for eight of the nine Governed Portfolios continue to fall within their target ranges. Governed Portfolio 8 has moved further beyond target.
  - The benchmarks and tactical positions for all three Managed Funds continue to fall within their target ranges.
  - Balanced Short and Adventurous Short Managed Strategy benchmarks continue to fall beyond their risk target.

The IAC thought it unlikely that long term assumed equity volatility would quickly revert back, as this would require a sustained period of equity volatility below historic average levels. The IAC agreed that it was now appropriate to consider changing the benchmarks of those portfolios that are near or beyond their risk targets so that customers are not subject to excessive risk (GPs 4, 7, 8, 9 and Balanced Short and Adventurous Short managed strategy benchmarks were highlighted for particular review). The IAC asked for a report to be prepared in conjunction with Barrie and Hibbert, for discussion at a special IAC meeting scheduled for 15th December. **PM/NL**

3. SHORT TERM TACTICAL VIEW OF THE RLAM CHIEF INVESTMENT OFFICER

RT advised that he was considering amending the tactical positioning that he had put in place across the portfolios in April 2009.

RT presented his short term tactical view:

The third quarter was one of the strongest quarters for risk assets in many years. With the worst of the economic and corporate news behind us the remainder of 2009 and into next year would see a consistently improving trend. Underlying this was the belief that the authority's policy stance will remain very accommodative for an extended period. The retail fund flows into corporate bonds on both sides of the Atlantic reached record proportions and flows into equities in Europe were also very strong.

While both credit, equities and to a lesser extent commercial property all benefited from accommodative policy, government bond markets only eked out low total returns for the quarter. We believe that QE is surprising yields and that as the policy is wound down so gilt prices will fall and yields will rise. Property has certainly been a beneficiary of the search for higher yielding assets with the distinct lack of available stock in the market turn encouraging further capital price increases.

October marked the first down month for many equity markets since February of this year and was probably brought about by the combination of economic/corporate news and the timeframe relating to the stimulus measures. We have started to see the central banks of a few countries start the process of taking back some of the exceptional policy largess that has benefited the markets over the last 9-12 months. While I don't see the policy being reversed any time soon, the financial markets more jittery mood has coincided with the first hints of reigning back. In addition I'm unconvinced that the recoveries in the developed economies are sufficiently robust to the extent of being able to withstand a tightening of policy. Therefore I still expect that short rates will stay very low for an extended period.

When we looked at the outlook for 2009 we believed that the pricing of risk assets was such that an extremely bearish outlook for the global economy was discounted and hence we were happy to have a raised exposure to both equities and corporate credit wherever possible. However when we survey the outlook for 2010 I believe that the range of potential outcomes is very significant. The global economy could continue its improving trend through next year or the recovery could stall as we pass the point of maximum benefit from the stimulus programs and the rest of the economy fail to sufficiently take up the reins. Given where risk assets are currently priced I believe more of the former scenario is factored in and that any doubts over economic progress would be taken badly.

The additional concern gaining attention is over the credit worthiness of developed economies themselves. This reflects the degree of debts that have been taken on by government which may prove an increasing burden if growth does not return to a *relatively robust trend soon. Such fears would clearly be a significant negative to government bond markets.*

In conclusion therefore having seen all asset classes benefit from current policy settings through this year I'm much more nervous on the outlook for 2010. However, I'm not sure that a more difficult economic situation next year will prove a positive for government bonds given the supply issues. Currently I see the most likely outcome for the year as a whole being that as the year on year momentum of improvement tails off so asset markets will struggle to make any headway. In terms of asset allocation I will be looking for opportunities to remove much or the entire bet on risk assets over the next few months.

4. SCOTTISH LIFE FUND REVIEW

Funds managed by RLAM

The following funds were identified for follow-up action at the next quarterly IAC meeting:

Fixed Interest Pension fund – NL explained that work continues with B&H to develop an "ex-ante" risk system. A proposal regarding the use of the risk budget associated with this fund will be submitted to the IAC at special meeting on 15th December 09. **NL**

Duration Bond funds – RT advised that the differences versus benchmark were due to the valuation points used, and the fact that the benchmark is calibrated quarterly whilst the fund is constantly managed to duration. The IAC were comfortable with this explanation and agreed that no further action was required.

Life Property fund – DB submitted a paper investigating ways to restructure the fund. The IAC agreed with conclusion that some form of pooling appears sensible, and asked DB to investigate the preferred option further. **DB**

Pension Property fund – it was noted that the fund pricing basis was changed to 'offer' in October 09, resulting in a significant increase in the fund price. It was also noted that there is now a net inflow of money into the fund, and that the cash holdings within the fund are currently relatively high. AC agreed to provide details to the IAC of the expected property purchases in the immediate future and the impact on the cash balance within the fund. **AC**

The following fund was identified as needing no further action:

Managed fund – it was noted that the difference in allocation between the managed fund and the respective governed portfolio has lessened.

Matrix funds

The following funds were identified for follow-up action at the next quarterly IAC meeting:

JP Morgan Premier Equity Growth – NL advised that the recommended replacement fund is the Cazenove UK Growth & Income Fund, subject to agreeing the commercial & legal terms. The new fund is AA OBSR rated and has a strong performance track record. It is also of a similar style and risk profile to the current fund, and is therefore deemed a suitable replacement. The IAC approved this recommendation. **NL**

Close Teams – reported performance continues to disappoint, although it was noted that some of this may be attributable to timing differences between benchmark and fund valuation point. The IAC requested a follow up report on these funds for discussion at the special meeting on 15th December. **NL**

BGI funds – RH reported that the reported BGI fund performance to end 30 Sept 09 is distorted due to extremely high market volatility exactly one year prior, on 30 September 2008. The IAC requested end October 09 figures to be produced to demonstrate this - to be submitted at 15th December meeting. **NL**

The following funds were highlighted as "on watch", and will be subject to further detailed scrutiny at the next quarterly IAC meeting:

Schroder UK Mid 250 – Fund performance has improved over the short term and it is noted that most UK mid cap funds within the sector underperform the mid cap benchmark. The fund is marginally under the benchmark over 1 year although longer term performance remains poor.

Fidelity International – Fund performance has improved over the short term but longer term figures are poor. It was noted that an underweight position in financials within the UK & Europe holdings has impacted performance.

Investec Global Free Enterprise – The fund is starting to produce positive returns after the prolonged period of high volatility Short term performance has significantly improved since last report, although longer term performance remains weak.

Artemis European Growth – The fund continues to be AA OBSR rated and it was noted that OBSR have advised that they have a high opinion of the team managing the fund and the process.

Fidelity European Blended – It was noted that the fund manager's fundamental approach in current markets has been detrimental to performance, as the manager did not participate in the low quality cyclical rally, a stance which resulted in weak short term performance. It was noted that OBSR continue to feel the process is robust and that the longer term track records for the underlying funds are better. **NL**

Other external managed funds

The following fund was identified for follow-up action:

Baillie Gifford fund range – Performance has been poor for some time and the IAC requested further investigation. **NL**

It was noted that legacy **INVESCO funds (not Invesco Perpetual funds)** will close on 11th December 2009 and that appropriate customer communications have been made. No further action is required.

5. ROYAL LONDON FUND RANGE

No funds in this range required to be placed “on watch”.

6. DATES FOR 2009 MEETINGS

Tuesday 15 December at 9:00am.

IMPORTANT INFORMATION

Please note that past performance is not a guide to the future. Prices can fall as well as rise. Investment returns may fluctuate and are not guaranteed.

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